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C O N F I D E N T I A L SECTION 01 OF 03 TEGUCIGALPA 002792

SIPDIS

TREASURY FOR U/S TAYLOR
TREASURY ALSO FOR RAMIN TOLOUI
STATE FOR WHA/CEN, WHA/EPSC, EB/IFD/OMA
STATE PASS AID FOR LAC/CEN

E.O. 12958: DECL: 11/28/2013
TAGS: EFIN ECON PGOV EAID ETRD EINV HO
SUBJECT: HONDURAS REACHES PRELIMINARY AGREEMENT WITH IMF ON PRGF PROGRAM - BALL IS NOW IN THE COURT OF HONDURAN CONGRESS

REF: A. TEGUCIGALPA 2648

¶B. TEGUCIGALPA 1581
¶C. TEGUCIGALPA 2662

Classified By: Ambassador Larry Palmer for reasons 1.5 (b) and (d).

¶1. (C) Summary. On November 25, the GOH and visiting IMF mission announced a preliminary agreement on a Letter of Intent (LOI) for a three-year Poverty Reduction and Growth Facility Program (PRGF). The central government deficit targets are 3.5 percent of GDP in 2004, 3.0 percent of GDP in 2005, and 2.5 percent of GDP in 2006. The program contains four prior actions that must be taken before the program can go to the IMF Board of Directors for approval. The first three require adoption of legislation by Congress of a government salary law, a new fiscal package of revenue and expenditure measures and a revised 2004 budget. The fourth prior action is adjustment of Honduras' poverty reduction strategy. The program includes requirements for adoption of new financial sector reforms, overall civil service reform, a new tax code, a prohibition on new agricultural debt bailouts, and pricing of electricity. The ball is now squarely in the court of the National Congress to adopt the necessary legislation in early December. All four of the prior actions will be politically unpopular and will touch on the interests of key political constituencies. At this point, however, it should be clear to the Congress that the measures are indispensable requirements if an IMF agreement is to be reached. End Summary.

¶2. (C) As planned, an IMF mission led by Adrienne Cheasty arrived during the week of November 10 to work with the GOH to pound out the long-awaited PRGF program. The negotiations began to founder during the second week as key legislators, including the President of Congress, came out publicly against new tax measures or a cut-back on teacher salary and benefit hikes, causing the GOH to back away from promises made in October. Over the November 22-23 weekend, the mission convinced the GOH that there was no further flexibility possible, and the hard legislative measures were absolutely necessary to obtain an IMF agreement. On November 25, the GOH announced that tentative agreement on a letter of intent was reached, but has not publicized the content. The program, as described to Emboffs by IMF and GOH officials, is similar to the proposal outlined in October (see ref A).

The Fiscal Targets

¶3. (C) The central government deficit targets in the draft LOI are: 3.5 percent of GDP in 2004, 3.0 percent of GDP in 2005, and 2.5 percent of GDP in 2006. The 2003 deficit is expected to be 5.5 percent of GDP, by IMF calculations (the GOH uses 4.5 percent, using a different accounting basis). For the consolidated public sector, the deficit targets in the draft LOI are: 3.0 percent of GDP in 2004, 2.5 percent of GDP in 2005, and 1.7 percent of GDP in 2006. Central government wage bill targets are 10.6 percent of GDP for 2004, 10.4 percent of GDP for 2005 and 10.0 percent for 2006. The program contains four prior actions that must be taken before the program can go to the IMF Board of Directors for approval. The program also includes requirements for adoption of new financial sector reforms, overall civil service reform, a new tax code, and a prohibition on new agricultural debt bailouts.

Prior Conditions

¶4. (C) The first prior condition is adoption by Congress of a government salary law that establishes executive branch control of central government wage policy (with raises keyed to inflation), folds the teachers into the unified civil service salary policy by June 2005, freezes the collateral benefits for public sector teachers and freezes salaries for medical personnel. The text of the law was discussed at length by IMF staff and the GOH, both in October and

November. The GOH has also mentioned returning to an alternative model of folding in the teachers: leaving the collateral benefits untouched, but stretching out the planned wage increases for 2004-2005 over four years. Although this would provide similar (perhaps slightly higher) fiscal relief, it would mean a further two-year delay in establishing executive branch control over teacher salaries to June 2007, and the IMF staff have tried to dissuade the GOH from pursuing it. However, President Maduro's advisors are continuing negotiations with the teachers unions over the form of the adjustment of teacher compensation. These negotiations are expected to continue for about a week.
¶5. (C) The second prior condition is adoption of a third fiscal package by Congress that results in at least one percent of GDP (about USD 60 million) in central government fiscal savings. The content of this fiscal package will be closely held for now, and is expected to include a fuel tax increase (0.5-0.6 percent of GDP) and other tax measures (tax on tobacco products and legislative action that implements fully the reduction in sales tax exemptions that were adopted in April 2003). On the expenditure side, 2004 government spending will be cut by 600 million lempiras, affecting all Ministries and government organizations that receive transfers from the Central Government. The GOH had originally proposed a much larger fuel tax increase to cover the fiscal gap for 2004, but the IMF staff had urged moderation (and compensation with other measures) because of the probable impact on the poor. Previous promises not to add more new taxes, by President Maduro and National Congress President Pepe Lobo, will complicate the passage of this legislation. However, given the size of the budget deficit, the lack of non-inflationary financing, and the disappointing results of the previous two fiscal packages, adoption is unavoidable for stabilization of GOH finances.

¶6. (C) The IMF Mission also is requiring a change of the 2004 budget (presented as required by law in September 2003) to reflect the lower expenditure envelope, before its adoption in December. The fourth prior action is the adjustment of the Poverty Reduction Strategy to reflect spending targets. IMF staff are also requiring publication in the Official Gazeta of the increase in electricity rates (keeps rates equal to marginal cost). The National Electricity Commission has already approved this rate hike, which will take effect January 1, 2004, but the decree has yet to be published (presumably due to political pressure). GOH interlocutors did not mention this issue.

Other Key Requirements in the PRGF Program

¶7. (C) In the negotiations, the GOH committed to enactment of a Financial Sector reform by June 2004 that will include a series of vital reforms for this very fragile banking system. The GOH will implement consolidated supervision of all financial intermediaries. Banks will be required to increase capitalization and provisioning for bad debts. There will be reforms to the Central Bank's role as a lender of last resort. This ambitious set of reforms is key to financial sector stability in October 2004, when the 100 percent government guarantee of bank deposits ends.

¶8. (C) The LOI includes mention of enactment of overall civil service reform in 2004. This is a key measure that was also included in Honduras' last PRGF program, and is a prior action for World Bank program loans. The IMF staff will be working closely with the World Bank to ensure the requirement is handled in a way that doesn't conflict with rules on cross-conditionality.

¶9. (C) The program also requires enactment of a new tax code in 2004 that, among other things, provides harsher sanctions for tax evasion. The GOH has been working on the text of this law for some time.

¶10. (C) The final program requirement mentioned by Embassy interlocutors is a prohibition on new bailouts for agricultural loans and a limitation on expenditures to implement the 2003 Agricultural Credit law (see ref B). The law authorized expenditures up to two billion lempiras for agricultural debt forgiveness, but the GOH has committed to limiting its share of cost to 1.2 billion lempiras and paying the smaller farmers first. Given the political influence of many of the larger beneficiaries and the continuous pressure for other bailouts, post expects implementation of this program condition will continue to be a struggle for the GOH over time.

Next Steps

¶11. (C) The GOH told the Fund staff there would be a 3-4 day delay before announcing the details of the preliminary agreement with the IMF to the public, to provide more time

for negotiations with unions and with key Congressional deputies. Although the GOH had previously planned to submit and obtain passage of needed legislation by November 28 (hence the urgency of the arrival of the IMF mission), National Congress President Porfirio Lobo has decided to keep the Congress in session during the first 20 days of December and consider any legislation related to the IMF program during that period (traditionally, the special December session of Congress only considers the budget).

¶12. (C) If the GOH submits and the Congress adopts the needed legislation in its entirety, without changes that affect fiscal targets, the IMF mission will send the LOI directly to the Board of Directors. The LOI will need to be reopened, however, if Congress makes substantive changes (the IMF mission believes its room for flexibility is now exhausted). If the GOH fails to send the laws to Congress, the efforts to reach an IMF program would go back to square one.

Comment

¶13. (C) The fiscal targets in the program are substantially looser than those sought by the IMF staff in previous visits, reflecting an enhanced understanding of the GOH's political constraints. All four of the prior actions will be unpopular politically and will touch negatively on the interests of key political constituencies. At this point, however, it should be clear to the Congress that the measures are indispensable if an IMF agreement is to be reached and macroeconomic stability is to be reestablished. Much will now depend on the GOH's and Congress' leadership in taking hard measures and explaining the need for them to the public. As indicated in ref C, post believes it likely that the Congress will approve the legislation and that the government can withstand any subsequent protests. End Comment.
Palmer